UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT, 1990

OVERVIEW

by the Secretary-General of UNCTAD

UNITED NATIONS

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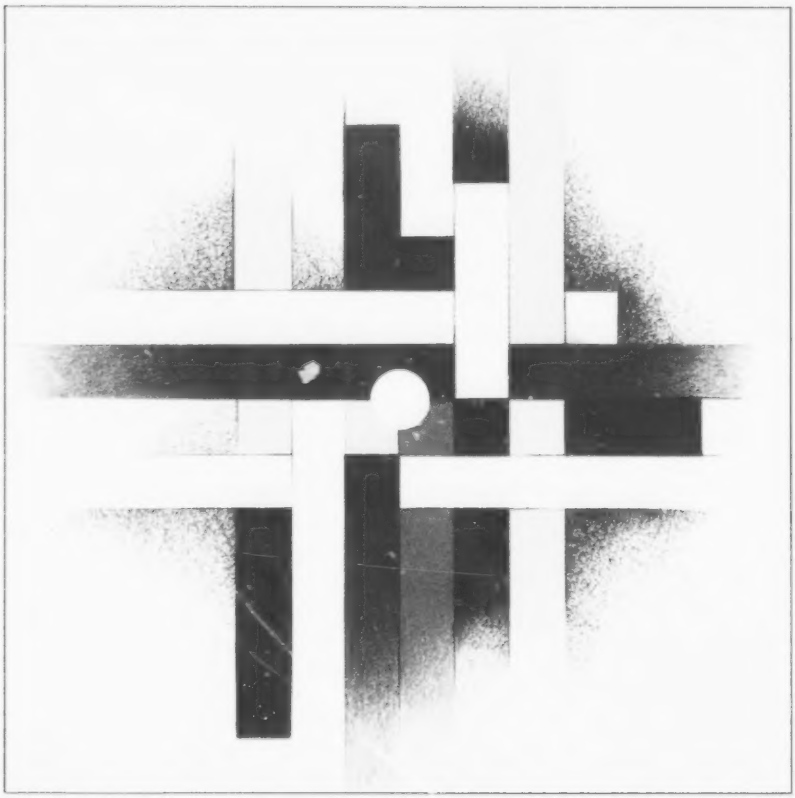

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
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OVERVIEW

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At the turn of the decade the world economy appears poised for a number of changes of far-reaching importance. These include the transformation of the economies of Eastern Europe and their integration into the world trading and financial systems; the creation of a single market in Western Europe; major reduction of the United States budget deficit, with the prospect of the United States ceasing to be a large net capital importer; and changes in the international trading system, following the conclusion of the Uruguay Round. In some of these areas - for example the creation of a single market in Europe in 1992 - the shape of the eventual outcome is reasonably clear, but its consequences for the world economy none the less remain uncertain. In others - for example the transformation of Eastern Europe and the assault on the United States budget deficit - the shape of the outcome is at present quite unclear, and the consequences of the policy initiatives under way therefore all the more uncertain. The outcome of the Uruguay Round is also difficult to foresee. Should it fail, there is a very real danger that the international trading system could become fragmented into a few powerful trading blocs and that the forces for managed trade could gain the upper hand, with negative consequences for developing countries.

These major changes are occurring at a time when the ascendency of finance over industry together with the globalization of finance have become underlying sources of instability and unpredictability in the world economy. Financial markets have for some time had an independent capacity to destabilize developing countries; there are now increasing indications of the vulnerability of all countries to financial crisis. The evidence indicates that the

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costs of financial liberalization and deregulation can be quite high; despite this, further liberalization of banking has become a major goal of some participants in the Uruguay Round. Overall, there appears to be a need for more collective control and guidance over international finance.

A large part of the developing world remains mired in economic stagnation that is often accompanied by various forms of financial disorder. The international debt strategy has made important advances, but policy responses - both national and international - often appear to be too little and too late. The task of breaking the vicious circle of poor growth, over-indebtedness and economic disorder remains for the decade ahead.

The policy challenge of the 1990s is to restore development while managing the rapid changes that are occurring in the world economy in a way that ensures that they contribute to the prosperity of all. This will be no easy task, requiring further policy innovation and adequate command over resources. The latter would be facilitated by overall economic buoyancy, but the near-term prospects are not encouraging. The world economy seems to be slipping into recession, a tendency that only some economies in Asia and some members of the EEC appear likely to resist.

The pace of activity in the world economy has decelerated markedly. World output, which grew at 4.3 per cent in 1988, and by more than 3 per cent in 1989, is expected to advance at around 2.5 per cent in 1990, and in both North America and Eastern Europe the balance of uncertainty in this forecast suggsts that it may be optimistic. The outlook for 1991 is for a small improvement in growth performance; on the whole, however, activity appears to be settling down at rates distinctly below those achieved in 1987-1988. In 1989 stagnation or slowdown of growth occurred in all major groups of countries, except in Africa.

Developing countries are recording highly divergent growth experiences. Output in Latin America barely rose in 1988 and 1989, and appears set to decline in 1990, so that since the early 1980s output per

head will have fallen by some 10 per cent, implying significant welfare losses. The improved performance in Africa simply brought to a halt the significant declines in output per head of the earlier period. Moreover, a number of countries in the region suffered economic setbacks. Growth in East and South Asia continued to be vigorous, though expansion in both areas slowed from previous high rates, and some signs of increased vulnerability were appearing in South Asia. The pace of activity in West Asia strengthened in 1989, but does not appear to be following the same course in 1990. For many countries, especially in Africa and Latin America, economic performance remained heavily influenced by the need to cope with external debt.

In China output growth has slowed markedly from the exceptionally high rates recorded in 1987-1988, following the initiation of adjustment policies to counter inflationary and balance-of- payments pressures.

As regards the developed market-economy countries, growth has weakened noticeably in North America. In Japan, on the other hand, activity remains relatively strong, as it does in Western Europe, with the notable exception of the Scandinavian countries and the United Kingdom. These developments mark a decided shift in the locus of growth dynamics, with continental Western Europe emerging as a major growth pole, and North America ceding this role which it had played throughout much of the 1980s. Policy in the United States is entering a particularly delicate phase, with further substantial adjustment of the budget balance likely to occur at a time of decided weakness in the economy.

Economic activity in the countries of Eastern Europe continues to be heavily influenced by the difficulties of engineering a transition to market-oriented economic structures. This process is in differing stages of evolution in the various countries, and at present a wide variety of approaches, time frames and desired final outcomes is in evidence. In many cases the old administrative system of economic governance is not functioning sufficiently, while the new mechanisms of economic regulation and market incentives have not yet become fully operational. The inevitable outcome is poor growth performance overall, a condition that appears likely to persist for some time into the future.

Adjustment and distribution

Patterns of growth and economic performance in 1989 and early 1990 in many respects marked the continuation of trends that emerged in the early 1980s, and which became more pronounced as the decade progressed. Some of these trends are a source of satisfaction - for example the high degree of success achieved by OECD member countries in sustaining expansion while containing price inflation. But others are far less favourable and some are a source of deep concern.

Foremost among the latter has been the tendency for the dichotomy between those doing well and those doing poorly to sharpen. Within many national economies, this has manifested itself as a worsening in the distribution of income. The costs of recessionary adjustment and macroeconomic disorder in Africa and Latin America have fallen disproportionately on the poor. In both continents the share of real wages in GNP declined during the 1980s. In a number of countries these shifts have pushed a larger proportion of the poor into absolute poverty in which even minimal nutritional needs cannot be met. The well-being of many in the middle social classes has also often deteriorated.

These same tendencies are mirrored at the international level. The 1980s have seen an enlargement - rather than a reduction - in the gap between income and wealth in the developed world and those of the developing world. During this period per capita output of OECD countries rose by about 2 per cent per annum. For developing countries as a group, however, output per head declined. Moreover, within the group of developing countries there emerged a further distinction between countries - mainly in Africa and Latin America - that consistently turned in poor growth performances, and in which per capita output declined sharply, and those - mainly in East Asia - where per capita output expanded (albeit at a rate below that recorded in the 1970s).

Thus, within the developing world itself fundamental differences in economic dynamics have emerged. These differences now defy simple explanation in terms of the usual economic analysis of structures,

markets and policies, and appear to be the product of cumulative forces that have become deeply entrenched. For countries caught in the vicious circle of low growth, excessive external indebtedness and internal economic and financial disorder, these cumulative forces are a matter of deep concern. A number of aspects of these negative dynamics are particularly worrying.

A first concern is the cumulative impact of the behaviour of investment. For a large number of debt-distressed developing countries investment remained throughout the 1980s at levels significantly below that reached in 1980. In some countries gross investment was so low that net investment must have been insignificant. The resulting deterioration in the stock of productive capital is now becoming increasingly evident in a number of countries, in particular as regards social and economic infrastructure. This in itself creates a severe handicap to future growth. An additional concern, however, is that stagnation in investment has necessarily entailed a slow-down in the pace of the technological up-dating of the productive base. This is contributing to a widening gap as between debt-distressed and other developing countries in their capacity to secure and utilize effectively the most modern forms of technology, and helps explain the differences in economic dynamics mentioned above.

A second concern is the deterioration in income distribution within debt-distressed countries, mentioned earlier. In addition to the serious fall in human welfare that this often entails, worsened income distribution increases the burden on economic policy: when such changes are not socially or politically sustainable, the need to reverse them heavily mortgages future gains in income, and the scope of future policy action.

The worsening of income distribution is in large part the product of the sheer size of the macroeconomic losses that were sustained by these economies, together with the particular social and political mechanisms in force in each country. The operation of the international system, however, also plays a role. Unskilled labour is not mobile internationally to any significant degree. Capital, on the other hand, is highly mobile - a mobility that is often facilitated by prevalent policy stances emphasizing liberalization of external payments. Highly edu-

cated nationals with internationally-marketable skills - individuals who are in the upper income brackets in their own countries - are also reasonably mobile. The upshot is that the overall macroeconomic burden of adjustment cannot be made to fall to any significant degree on capital or the highly skilled without provoking their migration - i.e. an acceleration of capital flight and the "brain drain". Specific policies to mitigate the impact of adjustment on the most vulnerable groups must be put in place and intensified. But as long as economies cannot be shielded from large macroeconomic losses, and upper income groups cannot be made to share to any great degree in those losses, a deterioration in income distribution is inevitable. It should be noted that an international debt strategy that is oriented toward improving the investment climate and encouraging the return of flight capital as instruments for overcoming the debt crisis (rather than incorporating them as factors that will follow the resolution of the crisis) works to intensify this phenomenon and thus to worsen the distribution of income in the short run, even though this is clearly not the intent.

A third concern is the resistance of inflation in some countries to policy action. An essential ingredient in mastering inflation is succeeding in changing the expectations of economic actors so that the sum of their individual decisions becomes consistent with a lowering of the rate of inflation. When Governments put forward anti-inflationary programmes that subsequently fail to meet their objectives, inflationary expectations can actually become more deeply ingrained, and inflation itself becomes more impervious to future policy action. This has undoubtedly already occurred in some countries.

A final, overriding concern is the extent to which the policy-making and policy-executing capacities of many countries have been - and continue to be - overloaded. There can be no doubt that improvements in both the formulation and execution of policy are often needed. But the exigencies of bringing about simultaneously reform, adjustment, stabilization and liberalization - and all of this within a relatively short time and in the context of reduced resources - while promoting growth, protecting the most vulnerable and dealing with the conflicting demands of various groups, would tax severely the most experienced and sophisticated governmental apparatus. When such an array of tasks is thrust upon administrations that are themselves in the

process of development, it should come as no surprise that objectives are frequently not met.

The external environment

A notable feature of the 1980s has been the changed relationship between economic performance in the North and the South. The deep recession experienced by OECD countries in 1980-1982 produced an external environment that was unfavourable to developing countries - because of its implications for interest rates, trade volumes and commodity prices. It was therefore widely expected that recovery in the OECD countries would foster recovery in developing countries. However, this did not turn out to be the prevalent pattern: most of the developing countries that performed poorly during recession in OECD countries performed equally poorly - or worse - during the OECD recovery, and most of the countries that performed well during the OECD recovery also performed reasonably well during the OECD recession.

For many countries that have done poorly, this outcome is explained in the first instance by the collapse of financial inflows, in particular bank lending. But it also reflects the fact that recovery in OECD countries in the 1980s has produced weaker growth impulses for developing countries than have previous periods of expansion. In particular, recovery failed to return interest rates and commodity prices to the ranges experienced during the 1960s and 1970s. Because of this, changes in the external parameters that had at first appeared to be mainly cyclical in character had to be viewed as longer-term changes requiring adjustments to the domestic economy that were - and continue to be - costly in terms of welfare and growth.

As regards interest rates, this outcome had much to do with policy stances in the major industrial countries, particularly the United States. The recovery of OECD economies in the early 1980s was characterized by considerable fiscal stimulus in the United States and high interest rates driven first by the policy of disinflation, and later by the need to protect the economy from a resurgence of inflation, given the fiscal stance. Throughout the 1980s the need to finance the fiscal deficit also exerted upward pressure on interest rates. Consequently,

although monetary policy passed through a number of distinct phases and interest rates came down from their peak, they none the less remained high throughout the expansion: the average real long-term rate of interest was 5 to 6 times higher than in the previous two cyclical expansions.

The failure of commodity prices to respond to the economic recovery in the OECD reflected a variety of factors: the investment boom in raw materials resulting from the previous high level of prices often resulted in oversupply; attempts by producer countries to increase export earnings in response to their external debt problems added further to supply; the sharp reduction of inflationary expectations in the OECD areas and the return to positive real interest rates reduced the demand for raw materials for speculative purposes; the raw material content of output in the OECD area was on a downward trend. In general, commodity prices during the upswing appear to have been governed as much by supply considerations as by the relatively weak growth of demand.

In retrospect, it can be seen that the shift in policy priorities in OECD countries, and in the relative roles of monetary and fiscal policy, virtually precluded the emergence of strong linkages between expansion in OECD countries and the foreign exchange availabilities of developing countries. The high priority assigned to combating inflation, together with the reliance of the United States exclusively on monetary policy as the macroeconomic regulator, meant that relatively low interest rates and relatively high commodity prices were an improbable combination: low interest rates would emerge when inflation was deemed to be firmly under control; that meant low and/or declining commodity prices. Any tendency for commodity prices to rise would be read in industrial countries as a resurgence of inflation and would trigger a response by the monetary authorities (even in circumstances in which interest rates were already high). Given the policy parameters of the 1980s, macromanagement in OECD countries was virtually assured to contribute to either weak commodity prices or high interest rates; often it contributed to both.

The recent decision of the United States Administration to seek agreement with Congress on a package of fiscal measures designed to

reduce the Federal budget deficit is of special significance. Should these efforts - which were still under way when this Report was being completed - be successful they could lead to a fundamental shift in policy parameters. A credible effort at budget deficit reduction would undoubtedly be accompanied by a relaxation of monetary policy and a lowering of interest rates, and any cyclical weakness in the pace of United States activity could be expected to reinforce this. The outcome that should be sought is a budget position that produces balance at high levels of activity in the United States economy, and real interest rates substantially below those recently experienced: monetary policy would retain its vigour and flexibility, but the range within which interest rates fluctuate would be moved permanently downward.

Such a shift in the parameters of United States macroeconomic policy would have a positive impact on the external environment for development, provided that it were effected in the context of rapid growth in the United States economy - an outcome that is by no means assured. For such a "soft landing" to materialize a number of difficulties will have to be skirted. Budget correction, taken by itself, will have an immediate and direct contractionary impact on the economy, as taxes are raised (thereby reducing private expenditure) and governmental outlays reduced (thereby reducing public expenditure). This contractionary impact should be offset by increased outlays induced by lower interest rates, but here the magnitude and timing of changes in private expenditure are much less certain, and investment decisions will be influenced negatively by the reduction in expenditure resulting from budget correction, as well as positively by the reduction in interest rates. Lower United States interest rates would probably lead to at least some weakening of the dollar and a strengthening of net exports. This would also help sustain the pace of activity. However, excessive weakness of the dollar would risk rekindling inflation and would undoubtedly be resisted. Consequently, should a large drop in interest rates prove necessary in the United States, this might be feasible only if there were some lowering of interest rates in other major financial centres. Other major industrial countries may therefore need to examine their own fiscal stances to ensure that they provide the monetary authorities with sufficient flexibility.

Trade issues

While the growth of world trade slowed significantly in 1989, relative to the preceding year, it continued to be strong (about 7.5 per cent in volume) and to outstrip the growth in world output. The fastest growing import markets were those of the EEC and Japan, reinforcing a trend that has been in evidence since the mid-1980s. In Japan, this growth is likely to continue into the future, as the expansion of domestic demand and particularly of public investment could remain strong. In Europe, imports will remain buoyant, as a consequence of fast economic growth. New investments, both domestic and foreign, in anticipation of the EEC's 1992 deadline for completing the internal market and strong demand stemming from German reunification will most probably lead to rapid growth in output, incomes and imports. Import growth in the United States could well decelerate further, as a result of recent dollar depreciation and weak overall demand conditions.

All in all, the outlook for world trade is relatively optimistic: the growth of trade could continue to outstrip the growth of output, two of the three largest import markets are likely to continue expanding briskly, and trade imbalances could show signs of correction, encouraging further growth in output and trade.

There are, however, a number of disquieting factors. The overall dichotomy among developing countries in growth performance, discussed above, was mirrored in trade performance: export growth has been strong in developing countries of East Asia, while other developing countries have not performed nearly as well. Export growth in Latin America has been very erratic, and exports have stagnated in sub-Saharan Africa. This uneven performance has been due partly to the commodity composition of exports of the different regions: primary commodities with slowly expanding demand and fluctuating prices predominate in the exports of Africa and several Latin American countries, while the Asian economies derive a large proportion of their export earnings from manufactures in high demand in the rapidly growing Japanese market. It also reflects long-standing differences in trade strategies. Finally, the debt crisis and the instability it has engendered have prevented some countries, particularly in Latin America, from building supply capabilities in manufactures.

The continuation of trade growth will depend to a large extent on the ability of the Uruguay Round to reverse the protectionist tendencies that have gained ground in the trade policies of most developed countries. Success in strengthening the multilateral trading system acquires particular importance because of the acceleration of economic integration in Europe and the emergence of a free trade area in North America.

Political and economic reform and progressive economic integration and co-operation in Europe have created a new dynamics that may lead eventually to the formation of a "Common European House". The new dynamics is bound to have implications for the export opportunities of developing countries. On the one hand, European economic growth will undoubtedly accelerate, and so may the demand for developing country exports. On the other hand, given the diversity of economic conditions and development levels in Europe, the pursuit of greater economic integration will give rise to the temptation to resort to protectionist policies towards third countries which could result in significant trade diversion. Political decisions at the highest levels may be needed to resist such temptation.

The rapidly evolving economic links between Eastern and Western Europe raise a number of issues in this regard. Several Eastern European countries are already seeking to enter into some form of association with EFTA and the EEC. While the situation is still quite fluid and difficult to predict, it is possible that these countries might obtain access to Western European markets on better terms than those granted to competing developing countries. In any case, sourcing in Eastern Europe and investment links which promote exports from East to West could be at the expense of developing country exports, especially if trade barriers against the latter are maintained or increased. Moreover, once economic reconstruction in Eastern Europe is underway, a hesitant approach by these countries toward opening their markets could be damaging to the export prospects of developing country exporters of manufactures. It could also deprive the Eastern European countries of cheaper sources of supply. These are possibilities which need to be forestalled, and the best way to do this is through the integration of the Eastern European countries into a strengthened multilateral trading system.

In the United States, the drift away from GATT disciplines on grounds of the unenforceability or lack of clarity of the relevant rules, and increasing resort to non-tariff measures, have been conspicuous. A particularly worrisome departure from multilateralism has been the increasing willingness to practice or threaten unilateral retaliation against trading partners perceived to be engaging in unfair trading practices, even in areas such as trade in services, intellectual property and foreign direct investment where no accepted international norms yet exist. In this environment, the move by the United States to enter into bilateral trade agreements with its neighbours has given rise to concern that, unless they are accompanied by adherence to multilateral disciplines and a rollback of existing non-tariff measures, such agreements could lead to significant trade losses for non-members.

The "Structural Impediments Initiative" (SII) talks with Japan are further evidence that the United States is attempting to broaden trade negotiations beyond what has traditionally been understood as their proper scope. In the SII talks, the United States' emphasis has been on Japan's domestic laws, regulations and business practices which are perceived as constituting barriers to United States exports to Japan and, therefore, as being partially responsible for its trade deficit with Japan. For its part, the United States has had to recognize that several of its own economic policies have had a bearing on the loss of competitiveness of its exports.

It may well be that in certain special circumstances the consequences for trading partners of domestic policies and institutions become appropriate objects of trade policy discussion. When this occurs, however, such discussions are best undertaken in a multilateral setting, where decisions can take into account the needs and interests of all trading partners. Moreover, any attempt to generalize the SII procedures would pose particular problems for developing countries. Development-oriented policies and institutional arrangements in developing countries have an influence on both the level and the composition of their imports and exports, and could be seen to have implications for the trade of other countries. But failure to recognize fully the need for such policies and institutional arrangements would jeopardize development itself. Moreover, a bilateral approach to the trade impact of do-

mestic policies would open the door to unwarranted intrusions by powerful countries into the domestic economic policies of weaker ones.

Most of the changes in economic structures and domestic policies agreed to in the SII talks are unlikely to have a significant impact on the United States bilateral trade deficit with Japan. One of the results of the SII talks, however, was a promise by Japan to increase public investment, thereby strengthening recent reliance on domestic demand as the main source of growth. At the same time, the United States promised to continue its efforts to reduce its budget deficit. Such actions are squarely in the macroeconomic field and have little to do with the direct and indirect market access issues with which United States trade policy has been preoccupied. Policy changes in this direction, by assisting in the reduction of long-standing international imbalances, would make an important contribution to an easing in protectionist pressures and to the preservation and strengthening of the multilateral open trading system.

The Japanese economy has undergone major changes since 1985. One of the most striking has been the emergence of an import boom as the economy has shifted from growth led by exports to growth led by domestic demand. Imports from a number of Asian developing countries have grown particularly rapidly. The recent surge in Japanese imports is a most welcome development, and its continuation should make an important contribution to world economic growth and to the exports of developing countries. However, in some quarters it is feared that the bulk of Japan's trade growth will be confined to a select group of Asian developing economies which are recipients of Japanese foreign direct investment and that countries, both developed and developing, which are not part of this network could be relatively disadvantaged when competing in the Japanese market.

There is some quantitative evidence that in some dynamic manufacturing sectors (particularly capital equipment) intra-firm trade of Japanese corporations has played an important role in the expansion of exports from the Asian developing economies to Japan. However, the bulk of the increase in these economies' exports to Japan has not been the outcome of the investment activities of Japanese corporations.

These economies have become competitive not only in the Japanese market but in other major markets as well. In addition, they have developed supply capabilities in those goods which have been in high demand in international markets. Generally, developing countries seeking rapid growth in exports to the Japanese market will have to emphasize policies which promote the efficient development of supply capabilities in goods which are, and will be, in strong demand in Japan. International assistance to overcome obstacles to productive investment would help to expand the number of developing countries in a position to take advantage of this growing market.

Capital markets and debt

1989 saw a continuation of the stark contrast between the overall buoyancy of international capital markets and the sluggishness of major categories of lending to developing countries. Net lending to developing countries by commercial banks remained negative. This stemmed largely from banks' efforts to reduce their exposure to countries in Africa and in Latin America and the Caribbean, because of their debt overhang. Overindebtedness was also an important force behind the continuing prevalence of the high costs and restrictive conditions of official insurance and guarantees for export credits, and low levels of demand for investment goods in developing countries. The upshot was stagnation in export credit flows.

The low perceived creditworthiness of most debtor developing countries has been strongly influenced by the failure of their external financial position to register sustained improvement. During 1989, such improvements as were forthcoming in ratios of debt to exports were to levels still above those of 1982, and were not accompanied by improvements in ratios of interest payments to exports, partly because of the rise in interest rates during the year. Net outward financial transfers from developing countries remained high, and arrears continued to increase for many major borrowers among them.

Commercial banks and the Brady initiative

The strengthened debt strategy, adopted following the Brady initiative, began to be implemented last year. Although this new approach marks a significant step forward, it promises to yield only half the amount of debt and debt service reduction needed by highly indebted countries. Its viability therefore depends, like the Baker plan, on the willingness of creditor banks to supply new money.

However, as explained in last year's *Trade and Development Report*, the willingness of banks to extend their exposure is questionable. The level of concerted bank lending dwindled to a mere $2.3 billion in 1989 (one fifth of the 1984 level). Some of the impediments to lending intensified. For instance, many banks further raised their loan-loss provisions, thereby adding to the cost of new lending, and arrears to commercial banks rose very steeply.

The banks' lack of interest in providing new money is also obvious from the experience of the three "Brady" agreements concluded thus far. (The agreements in principle reached by Morocco and Venezuela include a new money option; but it is not yet known what the banks' response will be).

- The Mexican agreement succeeded in eliciting only half the target set for new money, with many creditors opting instead for debt or debt service reduction.
- Subscriptions to the "new money bonds" offered by the Philippines fell short of the target figure, while more tenders were received for buy-backs than could be accommodated.
- The Costa Rican agreement made no attempt to raise new money and concentrated instead on debt and debt service reduction.

Since the agreements were negotiated without authoritative estimates of the debt and debt service reduction required by individual countries, it is difficult to judge their adequacy. However, some of their features are worrisome. First, outcomes were in most cases below expectations. Secondly, the remaining debt is more difficult to restructure, since it is now mainly in the form of bonds; moreover, these may come to be held by investors less willing to provide new money but more

willing to engage in litigation. Thirdly, the agreements are asymmetric regarding future contingencies: the creditors will gain if the country's position improves, but are not obliged to help if it deteriorates.

The absence of authoritative estimates of debt reduction needs, together with the failure to assign to any international financial agency the role of "honest broker", has left the level of debt reduction to be shaped by the balance of negotiating strength rather than by objective needs. In the Mexican deal, pressure on creditors by the United States Government helped to reduce this imbalance; but such pressure is not part of the architecture of the strengthened debt strategy. In the Costa Rican agreement, the creditors' willingness to conclude an agreement owed much to the decision of the Fund and Bank to provide financial support to the country's adjustment programme despite its arrears (reflecting the authorities' success in managing the consequences of these arrears for the domestic economy). Systematic resort to this approach where arrears are unavoidable, combined with firm internationally-set targets for the debtors' medium-term cash flow and debt profile, would give the negotiating process the anchor which it currently lacks.

Providing creditors with additional incentives to engage in debt and debt-service reduction on a larger scale and to accept steeper discounts in such operations could usefully complement increased pressures. A wide variety of proposals in this vein have been put forward in recent years (for instance, to establish an international debt facility), and have been discussed in previous issues of the *Trade and Development Report*.

National laws and regulations could also be directed more effectively towards achieving adequate levels of debt and debt-service reduction. One recent suggestion (made with European countries in mind) is that creditors should qualify for tax deductions on their loan-loss provisions only to the extent that they participate in debt reduction packages. Another (made with the United States in mind) is that creditors that fail to participate in debt reduction packages sanctioned by the IMF and World Bank should be required to make special provisions on their loans, and should not be eligible for tax relief on losses.

The broad conclusion is that the scale of debt and debt service reduction by commercial banks needs to be enlarged very considerably.

However, the combination of additional incentives and disincentives chosen in order to enlarge the scale of debt reductions should not be tilted in favour of increased financial support from the World Bank and the regional development banks. Unless additional funds are put at their disposal, such support could reduce lending for new investment, which is the key to successful adjustment.

Official debts

The relief resulting from the Toronto measures has proved to be very limited. As explained in last year's *Trade and Development Report* the eligibility criteria need to be reviewed, so as to increase considerably the number of beneficiary countries. As a first step, all least-developed countries and all IDA-eligible countries should benefit from the Toronto treatment. The recent agreement with Bolivia, which became the first country outside sub-Saharan Africa to benefit from the Toronto terms, is encouraging. The concessionality of the Paris Club measures should be enhanced considerably, especially for the most distressed countries, and the coverage of consolidation should be widened up to 100 per cent of Paris Club obligations. Multi-year rescheduling should be the rule, with the length of the consolidation period being related to financing needs rather than invariably being fixed to the length of IMF arrangements. Co-ordination between the Paris Club and donor groups should be strengthened, particularly to ensure that debt relief is not at the expense of aid. Finally, other bilateral creditors should consider the adoption of comparable measures.

Many middle-income developing countries whose debt is mostly owed to official creditors also have a debt overhang. Recent action within the Paris Club to extend longer repayment periods to some middle-income countries represents a step in the right direction but a timid one. Many debtor countries in this category will need reduction of their official bilateral debts. For them, debt reduction by commercial banks alone is not enough: official bilateral creditors also need to reduce their claims. Despite the difficulties involved - such as the impact on the finances of export credit agencies - this issue has been receiving closer attention by policy makers in creditor countries, as evidenced by

the initiatives most recently announced by the Presidents of France and the United States. However, these initiatives were not followed by agreement for global action on this important matter at the Houston summit.

For many developing countries, and especially some of the poorer, debt owed to the multilateral financial institutions represents an important part of their overall debt burden. Additional resources need to be brought to bear on this problem, so as to reduce debt and/or debt service payments when needed, and in a manner that safeguards the financial viability of those institutions.

Attention must also be paid to those countries that do not at the moment have an overt debt problem but are struggling to avoid that eventuality. The vulnerability of some of these countries has recently increased considerably.

International financial uncertainty

Last year witnessed further bouts of instability in financial markets. Shifts in exchange rates, interest rates, asset prices and the volume and direction of capital movements are now too frequent to be viewed as episodic. They are a characteristic of the global economy that has been emerging over the past two to three decades.

The volatility involves a very wide variety of monetary and financial instruments and is international in scope. Its intensity is due to the globalization of finance interacting with the new thrust of government policies which favour liberalizing and deregulating private finance and aim fiscal and monetary policies at nominal (as opposed to real) objectives. This shift sought to unleash initiative and enterprise. But since asset markets are ruled by changing expectations and temperament, its end result may have been, rather, to unshackle speculation.

Admittedly, thus far a global crisis has been avoided; indeed, the growth of the world economy as a whole has proceeded apace. Nevertheless, disruptions have not been absent, most notably in indebted developing countries. Moreover, the need to avert crisis and contain the spread of damage has obliged Governments to take actions inconsistent with their own economic philosophy and objectives. Besides, pro-

duction and trade continue to be subject to acute uncertainty and unpredictability because of financial turbulence. It is therefore none too early to consider how to diminish, if not remove, the instability of the international monetary and financial system.

By post-war standards, instability has been very high in the 1980s.

- Interest rates in the main financial centres have been much more variable, and the direction of movement has changed more frequently.
- The amplitude of fluctuations has risen even for countries with relatively low interest rates. Levels of nominal and real interest rates have reached extraordinary heights.
- The principal exchange rates have gyrated more in the past decade, and have deviated for substantial periods from levels warranted by differences in productivity and thrift.
- Swings in equity prices have registered an intensity unprecedented in the post-war period. The general level of equity prices has risen, but downward movements have at times been extraordinarily steep and abrupt.
- A number of developed countries have experienced sudden short-term inflows or outflows of funds on a massive scale.
- Many developing countries have experienced breakdowns in their external financing from capital markets, as well as large-scale capital flight.

One of the main sources of the increased instability is the liberalization and deregulation of financial activity. Since the late 1970s the removal of policy barriers to capital movements has become an objective of policy, and "hands-off" has pervaded official thinking generally. Moreover, attempts by countries to retain and attract financial activity to their shores has led to competitive deregulation and reduction of taxes, the principal result of which has been to make funds more mobile. Deregulation has also encompassed interest rates and the range of activities permitted to different types of financial institutions. This has reduced considerably the degree of segmentation of markets and widened the potential for funds to move across institutions, markets and borders.

The "hands-off" approach has also led to greater risk-taking. While some of the financial innovation characteristic of 1980s has been designed to spread risks, a good deal of it has been intended to exploit openings for capital gains on the basis of debt instruments. Because increased market freedom has not been adequately matched by prudential regulation, the lure of quick profits has put at risk not only imprudent creditors and debtors but the financial system as a whole.

Aided by advances in electronics, as well as by changes in government policy, the globalization of finance has proceeded rapidly. Its centrepiece has been the closer integration of national money markets as holders of liquid funds have increasingly regarded interest-bearing money-market instruments denominated in different currencies as potential substitutes for each other. Bond and equity markets too have become more closely integrated. These trends have been closely connected with the internationalization of industry, banking and various other services such as insurance. Fund managers have become increasingly alert to opportunities to improve their returns by continuously readjusting their portfolios, and borrowers have become more conscious of possibilities for raising funds from different markets abroad.

Financial integration, liberalization and deregulation have been the main factors causing international financial activity to expand rapidly. Growth in world output, trade and direct investment naturally causes international financial transactions of various kinds to grow as well. However, the latter's tempo has been very much faster.

International financial deepening does not appear to have improved the international allocation of savings. There has been no narrowing of differences in rates of return on capital investment in the major market economies, or in yields on financial assets with differing currency denominations but similar risk and maturity, or in real interest rates; nor has the link between the level of savings and investment in individual countries been weakened. The main reason is that most international financial transactions have been portfolio decisions, largely by rentiers, rather than business decisions by entrepreneurs.

Similarly most currency transactions have been generated by trade in the stock of financial assets rather than by flows of saving.

Consequently, foreign exchange markets have been ruled by expectations (including as to how currency expectations will evolve). The speculative component of the market has therefore predominated, giving rise to speculative "bubbles", "bandwagon effects", over-reactions and under-reactions to news, and sudden shifts of view even as regards the relationship between economic variables. It is therefore not surprising that exchange rates have shown no systematic tendency to move towards "equilibrium" values, and that speculation on future currency movements frequently has acted not as a stabilizing mechanism but as a source of turbulence.

The approach to policy followed by Governments has also been a major factor behind the increased instability. In the 1980s monetary policy became far less concerned to stabilize interest rates and much more concerned to control monetary growth. Governments have also become extremely reluctant to use fiscal policy to manage the level of demand, and even more so to control prices and incomes in order to combat inflation. This has left monetary policy as the only tool for macroeconomic management -- something not synonymous with controling the stock of money. Monetary policy has been further overloaded by the need to take account of the exchange rate. Moreover, Governments have failed to pay due regard to the impact of their own policy approaches and actions on the rest of the world. Consequently, major inconsistencies have emerged among the policy stances of countries, resulting in vast trade imbalances and sharp swings in exchange rates.

Exchange rate instability has inflicted damage on international trade and finance through two main routes.

- It has increased the cost of conducting trade, as well as the uncertanties faced by industries producing tradeable goods and services. Unpredictability has shortened the time-horizons for investment decisions, and made it necessary for firms to maintain higher mark-ups and financial reserves. Equally important, it has diminished the usefulness of the exchange rate as a signal for resource allocation, reducing the ability of depreciations and appreciations to alter exports and imports. Moreover, currency overvaluations have added to pressures for

protection; and the protectionist measures taken have often been maintained long after the overvaluation has ended. Continuous uncertainty regarding exchange rates has also encouraged pressures for permanent protection to compensate for the exchange risk.

- It has also tended to disrupt finance. For one thing, uncertainty in exchange-rates, like that in interest rates, has increased the preference of wealth-holders for liquid over long-term assets, and thus put upward pressure on long-term interest rates. Moreover, sudden shifts in exchange-rate expectations have set off movements of funds out of certain markets, for instance bonds and equities,on a scale large enough to depress prices very sharply (as in Japan in late 1989/early 1990). They have also made it necessary to tighten monetary policy (or created the expectation that this will occur), with similar consequences; pressure on the dollar played an important role in bringing about the Wall Street crash of October 1987. Attempts to counteract with monetary policy undesirable movements in exchange rates (eg. ones that are perverse from the standpoint of trade or which represent over-reactions to changes in trade imbalances) have in practice led to a ratcheting up of interest rates. This has added to other upward pressures, including those produced by the instability of exchange rates and interest rates.

High interest rates have had numerous adverse consequences.

- They have increased the cost of external debt in developing countries. This, together with the resulting increase in the volume and burden of internal debt, has had a devastating impact on macroeconomic stability, domestic interest rates, income distribution, investment, growth, and development.
- In developed market economies, higher interest rates have redistributed income in favour of rentiers at the expense of investment, wages and raw material prices. Although rates of profit have now regained their 1960s levels, the share of investment in income has not.

To remedy instability and reduce uncertainty to more tolerable levels requires action across a broad front, including the mobility of funds.

- Governments need to commit themselves to defend a publicly announced pattern of exchange rates which should be internationally agreed and compatible with high levels of activity and employment. Serious consideration should be given to establishing an EMS type arrangement (i.e. adjustible pegs with predefined obligations, intervention rules, and relatively narrow bands) between the dollar, the ECU and the yen.
- Multilateral surveillance of policies of major industrial countries should be much strengthened. In particular, targets need to be set for demand growth and current account balances. The burden of adjusting policy when outcomes deviate from those targets should be clearly specified. This burden should be shared between deficit and surplus countries in such a way as to avoid bias towards deflation and high interest rates; this is an especially important consideration for developing countries. Fiscal as well as monetary policies need to be included among the instruments of policy. Global targets and indicators should also be used to ensure that the world economy as a whole is neither deflated nor over-heated.
- The cost of speculation should be increased through policy intervention, using such devices as taxes on financial transactions. Considerable policy innovation in this area is called for.
- Prudential regulations need to be tightened to raise the cost of excessively risky operations in both credit and security markets. They also need to be harmonized, and applied in all major financial centres including those off-shore.

In order for the approach outlined above to command consensus, it would be necessary to recognize that financial markets need to be managed if they are to serve the needs of enterprise; that interdependence has already resulted in a loss of policy autonomy; and that in a multi-polar world co-operation is essential to prevent interdependence from accentuating conflict.

International banking and the Uruguay Round

The internationalization of finance has thus far affected the character of monetary and financial instruments more than the actors themselves. In most countries, the bulk of banking operations remains in the hands of domestically owned and controlled institutions. Moreover, most countries, including the majority of developing countries, maintain restrictions on cross-border capital movements and on foreigners' access to domestic financial markets.

Banking is an important subject at the multilateral negotiations on services taking place as part of the Uruguay Round. The impetus for an agreement on international trade in banking services as part of the Uruguay Round comes mainly from certain developed countries, their objectives concerning both each others' markets and those in developing countries. Banks from the developed countries clearly perceive widespread opportunities in developing country markets, particularly in the supply of certain retail banking services to the better-off and in the provision of services to corporations, the exploitation of which could be facilitated by an agreement at the current multilateral trade negotiations.

The costs and benefits of competition in banking and the relations between liberalizing the banking sector, on the one hand, and the conduct of monetary policy and the direction of credit allocation, on the other, need to considered in the context of efforts to establish an agreed regime for trade in banking services. Banking services generally play a pivotal role in the functioning of economies since a great many economic transactions are linked to their use. The banking sector is therefore a powerful instrument for controlling or influencing production and other major economic aggregates. As a result of banking's potential in this regard and of the large number of different services of which the sector consists, the establishment of norms and regulations in the field at national and international levels is a complex process, and frequently also a contentious one.

Proponents of an agreed regime generally are supporters of substantial liberalization, and point to analogies between restrictions of international competition in the provision of banking services, and quotas

and tariffs affecting trade in goods. For example, according to this view, restrictions on the establishment of foreign banks (and thus on "trade" in the form of financial services supplied locally by such institutions) lead via lower levels of competition to reduced innovativeness and microeconomic efficiency or to excess profits (or both) among banks already in the market. Restrictions on such banks' operations are thought to lead via increased costs to higher interest rates and other charges and to lower levels of lending. Thus liberalization of restrictions on the establishment and operations of foreign banks, it is believed, will improve the performance of financial sectors both with respect to the opportunities made available to depositors and investors for the placement of their funds and with respect to the amount and allocation of financing for borrowers.

For developing countries, liberalization of international trade in banking services also brings with it substantial dangers, which help to explain their widespread apprehensions.

- Commitments to liberalize cross-border transactions in banking services would entail dismantling significant parts of national regimes of exchange control. Some developing countries are already integrated with the financial world outside, either by deliberate choice or because of inability to exercise control over foreign exchange operations (due, for instance, to the extent of earnings from emigrants' remittances, tourism, illicit products, etc. or to the weaknesses in the national administration). But in many others this is not the case, and exchange controls have proved effective in stemming capital flight, thereby making an essential contribution to macroeconomic management.
- Unless subject to appropriate controls, the presence of foreign banks also would complicate the conduct of autonomous national monetary policies owing to the character of the banking operations which this presence facilitates, and to the lower degree of 'moral suasion' to which such banks tend to be susceptible.
- Economic development often requires direction of the allocation of credit. The liberal, market-driven banking systems

of the type currently prevailing in many OECD countries may therefore not be appropriate models to follow.

Much of the protection accorded to domestically owned and controlled banks in developing countries is of an infant-industry nature. The avoidance of financial dependence and the establishment of indigenous banking systems are an integral part of economic development. These objectives can generally be achieved only through the provision of appropriate protection and support to national institutions which would otherwise risk being swamped by the superior competitive strength of banks from the OECD area.

These dangers will need to be borne in mind and the issues they raise given proper weight in the Uruguay Round negotiations.

K.K.S Dadzie

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